KEYNES AND HAYEK*

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John Maynard Keynes and Friedrich Hayek are typically portrayed as intellectual rivals, and the differences between them juxtaposed in rather broad terms: Keynes as favouring government regulation of the economy, in particular control of the business cycle by deficit spending during a downturn; Hayek as favouring a free market economy with minimal intervention by the government. Now, although there are certainly elements of truth in such broad portrayals, the actual history is always more complicated, nuanced and, as an historian I am obliged to add, more interesting.

So what about the actual Keynes-Hayek relationship? The first, perhaps surprising, fact to note is that when Hayek was a college student in Vienna after World War I, Keynes was one of his heroes, as he was to many central Europeans after the war. This was because of Keynes's condemnation of the harsh terms of the Versailles Peace Treaty in his *Economic Consequences of the Peace*. Keynes's criticisms of the treaty had little effect, and Hayek was among those who witnessed first-hand the devastating hyperinflation that wiped out the savings of the middle classes in Austria and Germany in the early 1920s, which in many people's minds was instrumental in paving the way for the rise of fascism there. This gave Hayek a lifelong appreciation of the dangers of inflation.

About a decade later Hayek and Keynes crossed swords. In 1931, Hayek was invited to the London School of Economics to give four lectures on monetary theory. The lectures were published that year as a book with the title *Prices and Production*. People who attended later told him that he was nearly incomprehensible when he was reading the lectures, but whenever he answered questions he was quite clear. Of course nothing impresses an academic audience like someone being incomprehensible, so the end result was that they offered him a job.

In the summer of that year, even before he even began teaching, Hayek published a review of Keynes's new book, *A Treatise on Money,* a book that Keynes had been working on for years and which was supposed to establish his credentials as a major monetary theorist. This initiated a fierce debate over their respective theories of the business cycle.

I say fierce because it really was unprecedented: one of Keynes's fellow Cambridge economists chastised Keynes in print afterwards, likening his assault on Hayek to "bodyline bowling" – a reference to a particularly aggressive tactic used in the game of cricket, when the bowler aims for the batsman's body rather than for the wicket. It was a striking metaphor.

The grounds for the debate were really quite simple – both men had, in their respective theories of the cycle, drawn upon a framework that had been developed by the Swedish economist Knut Wicksell. Wicksell wrote in German. Hayek, of course, read German. Keynes, for his part, in a footnote in the *Treatise* made the fatally self-deprecating remark

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that "in German I can only clearly understand what I know already" (Keynes [1930] 2013, 178n2). It was as if Keynes had painted a bull's-eye on the cover of his book. Hayek's critique was that Keynes had only borrowed a portion of Wicksell's framework, ignoring completely the capital theoretic foundations that Wicksell had developed in another book. In contrast, Hayek had incorporated in an essential way Wicksell's capital theory into his.

In its own quiet way, Hayek's review was a polite but really quite devastating attack: he basically said that Keynes had not done his homework. (Gunnar Myrdal, who would share the Nobel Prize with Hayek some forty years later, was even less flattering, noting Keynes's book as an example of the British penchant for unnecessary originality.) If we recall that Keynes was a Cambridge don, the editor of *The Economic Journal*, and a major public figure in England, while Hayek, who at age thirty-one was sixteen years Keynes's junior, a young upstart from another county, and that this was all taking place as the downturn of 1930 was turning into the Great Depression, we can see that the stakes were pretty high.

Keynes was apoplectic about the review. His biographer noted that Keynes's copy of it was the most marked up document in Keynes's collection of writings by others. As is usual in the academic world, he expressed his displeasure by writing a response to it that was published a few months later. What was unusual is that Keynes used the review not simply to defend his own theory but also to attack Hayek's book. And what an attack it was! I will quote the most famous passage, which will give you some idea of the general tone: "The book, as it stands, seems to me to be one of the most frightful muddles I have ever read, with scarcely a sound proposition in it. … It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam" (Keynes 1931, 394).

Bodyline bowling indeed.

Both men eventually left the battle to work on new books. Keynes finished first, publishing in 1936 *The General Theory,* probably the most important book in twentieth-century economics, if one measures importance by the impact that it had on the thinking of economists and the practice of economic policy. Hayek's book, *The Pure Theory of Capital*, published five years later, was almost unreadable, frankly; and in any event little read. He was to make his mark with another book, published as the war was coming to an end, *The Road to Serfdom*.

There is a final twist to the story. Once the war had begun, the Keynes-Hayek relationship improved dramatically. They were on the same side in their recommendations for financing the war, with Hayek writing a strongly favourable review of Keynes's 1940 pamphlet, *How to Pay for the War*. When the Battle of Britain began, the London School of Economics was evacuated to Cambridge, and Keynes found Hayek rooms at King's College there. Finally, and most remarkably, after Keynes read *The Road to Serfdom* he sent Hayek a letter in which he said, "You will not expect me to accept quite all the economic dicta in it. But morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in a deeply moved agreement" (Keynes [1944] 1980, 385).

Hayek for his part said in a later interview, when asked to name the two people with whom he would most like to have a dinner and conversation with, it was Keynes and Joseph Schumpeter. So as I said, the actual relationship between these two men was more complicated and interesting than one might at first suppose.

That said, I would like to look briefly at what I see as the chief differences between Hayek and Keynes. One of these of course has to do with their analyses of the business cycle. I think that the best starting point is to say that both of them were fully cognizant of the fact that a market system is occasionally plagued by a business cycle. I say this for two reasons: first, it sometimes seems like people today are surprised that a cycle could ever happen. And second, Hayek is sometimes portrayed as someone who thought that markets always work just fine. This is a man whose first book was titled *Monetary Theory and the Trade Cycle.* Suffice it to say that Hayek was no Dr. Pangloss when it came to the workings of a market economy.

It turns out that Hayek's theory about the causes of a typical cycle offers a pretty good description of at least part of what happened in the latest meltdown, especially in terms of the Fed's interest rate policy and its effects on the housing sector. In Hayek's theory, problems start when the market rate of interest is held too low for too long. This always politically popular policy leads to malinvestment – too many investment projects get started that cannot ultimately be sustained. When people realize what has happened, investment spending collapses and a recession begins. Recessions are the painful but necessary adjustment that returns the system back to equilibrium.

Where Keynes and Hayek differed, of course, was in their response to the crisis. For Hayek, because a recession was the system moving itself back to equilibrium, he felt that any attempt to further inject credit into the system would just prolong the period of malinvestment, and ultimately set the stage for a bout of inflation later. Hayek's counsel to simply sit back and let the system adjust was as politically popular during the 1930s as it is today – it was a non-starter.

Hayek's fears about inflation did not materialize after the Great Depression ended. On the other hand, they did materialize during the stagflation of the 1970s that marked the end of the activist Keynesian policy in the United States. Which of these two episodes has more relevance for the downturn of 2008 is anyone's guess. The danger, as both Keynes and Hayek recognized, was that fiscal and monetary stimulus will go on for too long. In many people's minds, the question boils down to this: Will Washington have the requisite knowledge and political will to start reducing the stimulus at just the right time?

This scary question brings us to a second difference between Keynes and Hayek. It was captured beautifully by Keynes's biographer Sir Roy Harrod, who talked of "the presuppositions of 6 Harvey Road," (that was the Keynes' family address in Cambridge), the idea that "Reform, in the larger as in the smaller sphere, was to be achieved primarily and principally by the discussion of intelligent people. In all vital matters their views would prevail. Public opinion would be wisely guided" (Harrod 1951, 3).

Keynes was supremely confident that he and a small group of Oxbridge-trained experts could effectively manage the economy. Indeed, he was constantly making policy pronouncements, and often changing his mind, so much so that he was often criticized or caricatured in the press. After one notorious policy flip-flop, there was a cartoon of Keynes as "the boneless man," and there was even a riff on the old joke about economists: "When five economists gather, you get six different opinions, with two of them held by Keynes."

Hayek for his part often spoke about the limits of our knowledge and the hubris of reason: we just do not have enough knowledge to control something as complex as an economy. George Will recently quoted Hayek on this point: "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design" (Hayek 1988, 76).

He was also wary about the effects of government intervention on the ability of ordinary people to make decisions. As he wrote in *The Road to Serfdom,* "The more the state plans, the more difficult planning becomes for the individual" (Hayek [1944] 2007). The government itself can be one of the forces that induces uncertainty.

Taken by itself, Hayek's message about the limits of our knowledge suggests the importance of proceeding with caution. If one links it up with other arguments about the nature of the political process, for example those that are associated with the public choice school of James Buchanan, one's confidence that the political process will yield the right policy is further chastened.

Hayek's message, in short, is a much more depressing one than is Keynes's. But I will end with one of my favourite Keynes quotes, one that is always popular with my students. It is said that shortly before his death, Keynes was asked if there were anything that he would have done differently. He is supposed to have answered, "I would have drunk more champagne!"

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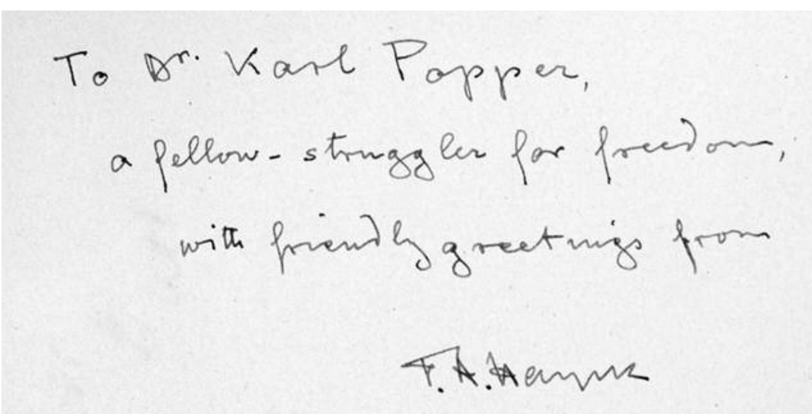

Hayek's dedication in *The Road to Serfdom* to Karl Popper
Hayekovo venovanie Karlovi Popperovi v knihe Cesta do nevoľníctva